



May 9, 2023

Honorable Mayor Weaver and Board of Commissioners:

Submitted is Hillsborough’s FY24-26 Annual Budget Workbook. The budget is prepared in accordance with the North Carolina Local Government Budget and Fiscal Control Act. As this proposed document is transmitted from the town manager to the Board of Commissioners, it now becomes the governing body’s budget to review, question, debate, adapt and ultimately adopt. It is expected that changes will be made to the proposed budget as new information becomes available and alternatives are considered. Town staff is ready to provide whatever information the board deems necessary to make well-informed decisions on the budget and financial plan. Therefore, the mayor, Board of Commissioners, advisory boards, and the community are encouraged to share their views regarding what should be funded or modified because this is ultimately your budget!

The multi-year forecasting component of this document, used since 1998, makes it easier to look forward and identify, address, and mitigate potential problems while they are still manageable. The plan allows readers to see how today’s decisions affect the town’s financial condition in the future. The financial plan acts as a “fiscal radar,” giving Hillsborough more time and flexibility to proactively plan responses to problems and needs. Using only a one-year view from the annual budget, as most local governments do to manage operations provides little advanced warning of problems looming on the horizon. Hillsborough is one of the only local governments in North Carolina using a multi-year budget format. While only the first year of the budget is legally binding, years two and three of the financial plan include critical information that provides a more accurate picture of the fiscal and operational challenges facing the town.

Strategic Plan Progress. A strategic plan identifies an organization’s top priorities then links those to implementation actions, performance measures, and timelines to monitor progress, identify successes, failures, and when adjustments to the course may be needed. The town’s previous strategic planning format, “the balanced scorecard,” was retired in 2019 after 11 years. Increasing and new challenges brought on by growth necessitated a change to develop a new format that is easier to follow and better focuses on the higher volume and complexity of Hillsborough’s pressing priorities. Staff are continuing to work on plan development, making revisions based on feedback that was provided by the board at the budget retreat. An updated plan will be presented to the board in June.



Priority #1 in Developing the FY24-26 Budget & Financial Plan

“Taking care of what we have” has been the unofficial motto of the town board and staff for many years when making budget decisions. This refers to the town’s infrastructure, equipment, buildings, employees, and systems. The town’s mission, vision, strategic priorities, and objectives can’t be implemented if these basic tools of service implementation are not in working order. The longer a municipality waits to repair or replace these assets (tangible and intangible), the more expensive it becomes in the long term. Governments are notorious for building capital assets and not adequately maintaining them.

Construction of new assets must be balanced with the personnel, equipment, and organization to operate and maintain them. This is critical in avoiding the overextension of resources. As shown in the image below, the American Society of Civil Engineers’ most recent report card shows the poor state of our country’s infrastructure. This is an excellent reminder to avoid the errors others routinely make in budget prioritization and ensure we are properly maintaining Hillsborough’s assets!



Successful companies understand the importance of funding depreciation to save, set funds aside, or take other actions to not just maintain capital assets but to plan for their replacement. It's easy to ignore or forget about the thousands of miles of underground pipes, pump stations, wiring, and electrical systems for our water, sewer, and stormwater systems that are hidden from sight and thus easily forgotten. The same is true about the base layers of our roads, integrity of buildings, parks, trails, and other public assets. Many of the town's utility assets have exceeded their practical life and need replacement, which only gets more expensive the longer we wait. Many water, sewer, and stormwater assets are over 50 years old, with some being over 90 years of age, such as the Hasell Street water tank.

Failing to attend to these needs is like deciding not to replace the aging roof on one's home to save a few dollars today and ignoring the major financial risks and disruptions that come with such choices. Significant infrastructure failures of all types are now regular occurrences in the news. While "taking care of what we have" has provided helpful guidance, we are still lagging in addressing many capital needs. Thus, this financial plan (FY24-26) and capital improvement plan (FY24-30) include tens of millions of dollars to maintain the foundations of the town's operations, the water, sewer, and stormwater

systems, as well as buildings and other critical assets.

Investing beyond physical assets. The past three years since COVID-19 started have highlighted the importance of being able to recruit and retain employees for the many unique skill sets involved in operating local government services. Difficulties in retaining employees and the ability to fill key positions with skilled and experienced people has become a national crisis in many occupational areas, from health care to restaurants, skilled trades, and many others. Local governments and the Town of Hillsborough have not been immune from this problem. The competition to retain and recruit talent has risen to levels never seen before and is driving salaries significantly higher. The town made mid-year salary adjustments in FY22 as a stop gap measure to buy time to complete a compensation and classification study, which was implemented in October 2022. This major investment was a big step in helping our ability to keep many of our talented employees as well as make new hires, both of which have been difficult to do in recent years.

Even though these positive steps were taken to not fall too far behind the market, neighboring competitors have continued to raise their salaries, thus this is an area we must closely monitor to avoid falling behind again and risk losing our biggest asset – employee knowledge, skill, and experience. Unfortunately, we have too many examples of the damage that can be done when key talent is lost, and critical skillsets are not adequately replaced.

Three Unique Challenges in Preparing the FY24-26 Budget & Financial Plan

The explanations below briefly explain some major complications that have made preparing this year's budgets more difficult than usual.

- ✓ FY22 Annual Financial Report (AFR or audit) is late and FY23 (current year) revenue and expenditure postings are just now catching up due to staff shortages and the focus on completing the FY21 audit, which was completed in January 2023. Budget staff just recently received the FY22 actual numbers which means there's been limited time to update and refine projections, as well as generate operational and financial strategies. The reasons for this are well known, the financial services department experienced significant staff turnover during the past two years. These gaps required the use of several interim directors, outside accounting and financial consultants, other departments assisting with finance operations, and existing staff taking on more responsibility that was often outside of their primary duties and experience. This created many gaps and delays in reporting. The town was placed on the Unit Assistance List (UAL) by the Local Government Commission in July 2022 since the audit had not been complete. Being on the UAL placed additional reporting and process requirements on the town. Many other local governments have found themselves in a similar situation due to the statewide shortage of accounting staff, finance directors, and auditors who can perform this specialized work. As a result, nearly 25% of units were on the UAL at one time. As of March 2023, 131 local government units still had not submitted their FY22 audits.

Good news - significant progress has been made in recent months. The FY21 Annual Financial Report (audit) was completed in January 2023 and the financial metrics looked strong. The FY22 audit is nearly complete and should be presented to the board shortly, likely at the June 12 board meeting. A new finance director with significant local government experience started in February, there has been no recent turnover within the financial services staff, the team has been gaining excellent experience, and the department is in the process of filling two final vacancies.

- ✓ Inflation, cost escalation of construction projects, and threat of a recession. Will it be a hard, medium, or soft landing as inflation reached a 40-year high a year ago? The rate of inflation has slowed the past year, but it is still around six percent. Regardless of commodity or service, prices continue to increase. This is reflected in many of the operational line items in the budget. One example is the cost of chemicals for the water plant that are projected to more than double, from \$199,000 in FY23 to \$425,000 in FY24. While that is just one line item in the town budget, inflation has had a major impact in many expense lines and departments. Local governments are regularly seeing bids on building construction, water, and sewer projects, and just about anything else, often doubling in cost over engineer's estimates. Estimating costs for projects today, much less three years from now, is problematic. If this trend continues, it could require a dramatic shift in operational and capital planning because the town would not be able to afford many of the items currently budgeted and forecasted. For example, if the River Pump Station bids come in at \$17 million instead of the estimated \$8.5 million, this will have a severe cascading impact on the ability to address the tens of millions of dollars of other system priorities.
- ✓ System Development Fees (SDFs) difficult to forecast. SDFs (formerly called capital facility fees) are paid by new development to help cover their fair share, volume, or equivalent impact on the capacity of a utility system's water and sewer capacity levels. This usually relates to the cost of improvements or expansion that have been made to a water plant, wastewater plant, reservoir, and other factors. The SDFs are calculated by engineering firms and updated every five years by state law. Uncertainty about when approved developments, such as the next phases of Collins Ridge and other projects will proceed and when those fees will be paid can have a significant impact on when the many capital projects get started and how they are paid (e.g., SDFs, savings, debt, or grants). Thus, the safest way is to delay forecasting these revenues until they are received or there is a high level of confidence when they will be available to pay for capital projects. As the town has learned in the past, a recession or troubles for a particular development can delay projects for years.

While new developments can bring revenues, they also bring offsetting costs and operational complexities. SDFs from recently proposed developments would provide millions of dollars that are not included in the current forecast since it's too risky to do so at this time. As developments get approved or declined, staff can be more precise in determining how to use these funds to pay for capital needs and thus creating less reliance on rates for payment. The advantage of using SDFs strategically is that it can provide the option of paying cash for certain projects, not increasing the debt burden, and reducing pressure on rates to fund capital needs. Part of the seven-to-ten-year capital financing plan for water and sewer that staff will begin to work on after budget adoption is to develop options on how to best leverage all funds, including the significant amount of SDFs from future development that are needed to help pay for assets that were built to accommodate future growth and economic development.

Tax and Rate Highlights

- ✓ Property tax. **No change – rate is recommended to remain at 58.7 cents.** If approved, this means there will have only been one property tax rate increase over the past 11 years, which was the two-cent increase earmarked annually for climate and sustainability priorities in FY22. This could change as a key decision point for the town board in this year's budget as well as over the next few years is determining how to fund the commitment to dedicate the equivalent of 2 cents on the tax rate (\$326,000) towards affordable housing.
- ✓ Water rates. **6% increase is recommended.** While the FY24 deficit is \$1,612,045 with a 15.4% rate increase needed to break even each of the next three years, the reason for recommending a smaller increase is to take a step toward addressing the gap and focusing on building a Capital Financing Plan for water and sewer once the budget and audit are completed in June. This will provide time to explore options to minimize future rate impacts, yet still make critical investments into the water and sewer systems. This is discussed further in the Water and Sewer Fund Highlights section below.
- ✓ Sewer rates. **6% increase recommended.** While the FY24 deficit is \$696,214 with an 8.4% rate increase required to break even each of the next three years, the reason for recommending a smaller increase is to take a step toward addressing the gap and focusing on building the Capital Financing Plan discussed above.

- ✓ Water & sewer minimum rates. **Continues three-year (four fiscal year budget cycles) plan to decrease monthly charge from 2,500 to 2,000 gallons.** This decreases the monthly minimum charge by 125 gallons per fiscal year. FY24 will be the next to last adjustment period with the minimum rate decreasing from 2,250 to 2,125. The town board made this decision during the FY22 budget process to provide relief and a more equitable way of charging low volume customers, who are often on fixed incomes, elderly, or living alone. This builds on the similar initiative recommended by the Water & Sewer Advisory Committee and approved by the town board that decreased the minimum rate from 3,000 to 2,500 gallons over the four-year period from FY14 - FY17. In addition to providing an incentive for customers in this use category to conserve, the change provided substantial relief to lower volume users. The FY22-25 reductions take the prior FY14-17 efforts a step further. Of the 54% of water systems that use the volumetric charge, as opposed to a base rate, the most typical monthly minimum charges are in the 2,000 to 3,000 per month range. Thus, in FY24 when the minimum rate drops to 2,000, Hillsborough will be at the most equitable end of the range when it comes to this rate method.
- ✓ Stormwater rates. **No change to the annual fee.** A preliminary option was presented by staff at the budget retreat about the need to raise the annual fee and make changes to the rate structure to account for lots more accurately with larger areas of impervious surface. It's recommended to delay the stormwater increase and rate structure changes another year to provide more time to assess the costs of upcoming stormwater requirements as well as rate structure options. The fund will be operating at a deficit but there is sufficient fund balance to cover the gap for FY24.

General Fund Highlights

- ✓ Financial Overview. As is often the case, the budget and three-year financial plan projects deficits due to being conservative on revenue projections and cautious on expenditure amounts. After the audit, most years end up with deficits being less than projected or with an actual surplus generated. With that said, the projected deficits in the General Fund are large enough to give me some pause and thus it's important to discuss expansion items during the budget workshop(s) to ensure they align with the town board's priorities and assessment of Hillsborough's needs. It may be that some requests need to be deferred or alternatives found to scale back. The projected deficits and over the next three years are as follows:
 - ✓ FY24 - \$970,060 (5.9% deficit)
 - ✓ FY25 - \$1,432,366 (8.7% deficit)
 - ✓ FY26 - \$1,627,015 (9.5% deficit)

The following are a few points to consider when weighing the approach to this budget and financial plan (i.e., what is an appropriate deficit level):

- Fund balance level strong. Even with those levels of deficits, the fund balance at the end of FY26 or Year 3 of the Financial Plan is 43.1%. We don't want the savings level to drop that low and would take corrective action in advance since it's difficult and painful to correct a large deficit amount in one year. Still, the savings accrued during the recent COVID years provide a little cushion to use fund balance to address some high priority needs.
- Stop, pause, cut, and defer expenses mid-year if needed. With the threat of a recession, it's important to time new hires, initiatives, and projects. Three of the new positions are scheduled as mid-year (January 1) hires. Thus, if the budget or economy is looking bad those positions can be deferred until FY25 or later. The same can be done with other items in the budget, whether it be small or large capital.
- Continued growth should bring additional revenue. There are still about 800 residential units to be completed in Collins Ridge, along with about 442 units approved in the newly annexed Moren property off Old NC 86 adjacent to Waterstone, along with other pending developments. Working to minimize new expenses related to serving these projects via absorbing with current assets and staff can provide resources to pay for portions of longer term and expensive projects that are in the Capital Improvements Plan.
- Sales tax elasticity. This revenue source is hard to project so it's always safest to be cautious. Almost no growth is projected during the three-year plan. If the economy is a bit better than projected, a small improvement can be a big help in reducing deficits.
- Contingency increased. General Fund contingency is raised from \$300,000 to \$500,000 to provide some additional buffer. In recent years \$300,000 has either been fully used or not enough. Inflation on various items has hit harder in recent years as things such as vehicle and truck purchases regularly come in higher than budgeted, so contingency has been used more frequently. The maximum level of contingency per fund is five percent, which would be about \$800,000, so our contingency level is still modest for a budget this size.
- Getting back on a regular audit cycle. As the financial services department is catching up, with a new finance director now on board, final vacancies being filled, and other internal improvements being made, there seems to

be a good probability we will have the FY23 audit completed well ahead of prior years and hopefully much closer to the Local Government Commission's official deadline of October 31. If concerns or issues are identified in the audit, such as revenues being down, expenses unexpectedly being high, and lower than projected fund balance levels, staff can make corrections before mid-fiscal year to cut costs in FY24 if needed.

- Multi-year financial plan. As mentioned on the first page of this message, one advantage of using the three-year budget and financial plan format is that it provides additional warning that corrections need to be made. Thus, when corrections need to be made in the scale or pace of how new expansion items are added into the budget the brakes can be pumped to slow or stop spending. While this year's budget includes and addresses many needs, next year's plan may have a very different approach.

- ✓ Passenger Rail/Multi-Modal Station. The station will also include town offices. Funding for this approximately \$8 million project is in a separate project fund. The primary sources of revenue (\$6 million) come from the State Transportation Improvement Program (TIP) and the NCDOT Rail TIP. The town will be responsible for any costs over that amount and for the cost of the town offices. The 30% plans are nearing completion. Construction is anticipated to start in 2025 and to be completed by February 2028.

- ✓ Ridgewalk Greenway Phase I Design - Downtown to Train Station. The FY24 cost is \$209,003 with total design at \$450,000 for this section. When fully completed the southern greenway system will pass through Collins Ridge, cross I-85 via a pedestrian bridge, and end at Cates Creek Park. A feasibility study and schematic design of the greenway is the necessary first step. If the project is found to not be feasible then funds for design and construction would not be needed.

- ✓ Ridgewalk Greenway Phase 1 – Start Savings to Pay for the Project. Begin by including \$50,000 in the FY24 budget, then increase by an additional \$50,000 annually over seven years to “ramp up” to reach the amount needed to make the yearly debt service payments of \$582,771, over 10 years for this projected \$4.5 million project expected to be completed in FY28. The “ramp up” only generates \$350,000 of annual debt service capacity. The remaining amount will be offset by reserved parks debt capacity of \$232,355. Banked funds can be used to offset project costs (e.g., lower the amount that needs to be borrowed, pay for cost escalations, and/or cover debt payments until full coverage is met in FY30).

- ✓ Skate Park at Cates Creek Park (\$300,000). Construction was originally scheduled for FY25, but the town board requested this be moved up one year, if feasible. Design is currently underway and thus the project should be ready for construction sometime in FY24.

- ✓ Climate & sustainability. When adopting the FY22 budget, the town board directed that the equivalent revenue of approximately two cents on the property tax rate be saved and used to address climate and sustainability priorities. The FY23 and FY24 budgets also included the same level of funding to assist with priority implementation identified in the Comprehensive Sustainability Plan scheduled for adoption in mid-2023. Thus, there will be over \$900,000 available for appropriation, if desired, in FY24. The Public Space and Sustainability Manager recommends that \$600,000 be transferred to the Train Station Project Fund to pay for a solar array at the new train station. Sometime after the Comprehensive Sustainability Plan is adopted this summer there needs to be discussion about how to incorporate the plan's priorities into the town's Capital Improvement Plan (CIP), future budgets, as well as when and what to spend those funds dedicated to sustainability from the 2-cent earmark. This may be a major part of next year's budget process (FY25-27). Revenues from the 2 cents will be helpful but are likely just a small portion of the funding needed to implement top priorities from the Comprehensive Sustainability Plan.

- ✓ Affordable Housing. This is a top concern and challenge in many communities throughout the country. Just five years ago Hillsborough's budget included less than \$10,000 in this area. To advance progress on affordable housing, the town board adopted guiding principles in April 2022 to incrementally increase funding over several years to allocate the equivalent of two cents on the property tax rate to this need. This paralleled a request made by the Affordable Housing Coalition in Orange County to help prioritize affordable housing in an on-going and meaningful way.

Funding in FY22 was \$22,488 with \$68,066 budgeted in FY23. FY24 funding requests have been received from the Partnership to End Homelessness (PEH) as well as the Inter-Faith Council (IFC) in Chapel Hill to support their shelter operations that are available to all in Orange County. The town board has also expressed a desire to retain the capacity to assist other entities in the creation of affordable units. Funds the town has used in the past to assist with various projects in Hillsborough are now exhausted, so rebuilding reserves to assist in this area is needed.

Key decision points for the board during the budget process include:

- How to reach the 2-cent equivalent?
 - One option is to absorb this expense in FY24 to avoid a property tax rate increase this year, start phasing in next year, or select one year to increase the property tax rate accordingly. This is an important point to resolve since the current budget is not capable of absorbing this expense without corresponding cuts, deferments, or identifying a revenue source such as raising the property tax rate to cover the \$326,000 cost of the 2-cent commitment.
 - The budget includes a proposal to make annual steps to the 2-cent goal. FY24 includes a total of \$100,000, then it increases by about \$75,000 annually until FY27.
 - Confirm or amend allocation to PEH of uncommitted FY23 funds (\$43,292). A budget assumption to continue these funds was made since they already had an existing engagement with the town.
 - Will FY23 funding be provided to IFC?
 - What to do about FY24 requests from PEH (an additional \$51,475) and IFC (\$43,518)?
 - How much and when to start allocating towards the “Affordable Housing Creation Reserves” for unit development in Hillsborough?
- ✓ Public Works facility and relocation (\$4.52 million). After being in the flood plain, in substandard facilities, with no equipment shelters, and little storage for about 50 years, funds are allocated in FY24-26 to move the Public Works Division from their Dimmock’s Mill Road location to the NC 86 North facility. Annual debt payments of \$361,092 start in FY25.
- ✓ Fire protection contract with Orange Rural Fire Department (ORFD). Pay study results found ORFD salaries to be 15% below the market. Total cost of implementation is \$275,598, with the town covering 50% (\$137,799). In addition, the annual contract with ORFD increases by 8% for FY24. ORFD is experiencing the same challenges from inflationary cost impacts and growth as other entities.
- ✓ Downtown fire station. The town is responsible for building and paying for the new downtown station at 604/618 North Churton Street, the old furniture store site. The new downtown station is estimated to cost approximately \$5 million in three years. Funds were included for the first time in FY22 (\$75,000) and increased by \$75,000 annually to “ramp up” to the eventual annual debt service amount. FY23 included \$150,000, \$225,000 is in the FY24 budget, \$300,000 in FY25, and \$375,000 in FY26, which should be close to the anticipated annual payments going forward. These funds are being placed in a capital project fund to help pay for design costs first, then transition to funding the annual debt. “Ramping up” to the annual debt service amount prevents other items from crowding out the ability to pay for this top priority. Relocating the old fire station provides a modern facility for ORFD, improves overall coverage, provides an Emergency Operations Center for the town, and allows the current station and downtown property to be redeveloped as part of a future economic development project. The process of selecting an architect to begin design could start as early as next summer (July 2024).
- ✓ Waterstone Drive repaving (\$950,000). This represents about twice the annual cost to maintain the town’s streets resurfacing cycle. It is less expensive to follow this cycle of repaving about five percent of the road miles as it prevents severe deterioration that costs even more to repair when delayed. The significant cost of this project is partially due to the length of four lane miles, because the pavement must be milled down so the new layer of asphalt will be even with the base of the curbing, and increased construction costs. The project should not be delayed since critical areas were patched in FY23, thus delaying the project means that work may need to be redone. All the anticipated Powell Bill fund balance (state gas tax savings - \$473,000) will be spent to pay for the project and minimize the impact on the FY24 budget.
- ✓ Unified Development Ordinance re-write (\$95,000). The town and development landscape has changed dramatically since the Unified Development Ordinance (UDO) was adopted in 2011. Development regulations have changed at the state level and the town knows a great deal more now about its capacity for future public water and sewer service extension and where we can and cannot reasonably grow. UDO regulations do not fully address traffic increases from development and developer responsibility for mitigation. The desire to be a more walkable, sustainable, connected community can only be achieved through revision of current development regulations to require the kind of development that we want to see.
- ✓ Support for Fairview Community Watch and Dorothy N. Johnson Community Center (\$40,000). Building on the work of Fairview Community Watch, Habitat for Humanity and the UNC Community Practice Lab, staff are recommending \$40,000 in one-time funding for FY24 as initial support for the *Vitalize* plan. A portion of the proposed funding, \$34,000, will go towards improvements at the Community Center (classrooms, exterior improvements, operating costs) and \$6,000 will go towards programming and community events. Staff received an additional request for \$10,000 to support staffing for the

community center, but more discussion is needed before that request can be supported. A budget amendment may be pursued later in the year if needed.

- ✓ Accounting and finance software replacement. This has been scheduled for several years but not implemented due to staff shortages. In addition to the current software being outdated, several different systems are used for billing, accounting, purchasing, payroll, accounts receivable, and most do not integrate with the current software and many manual and other cumbersome methods of getting data into the General Ledger must be done. The annual cost of the new system is budgeted at \$75,310 starting in FY24. This will significantly improve efficiency, reduce wasted time for the accounting division, all departments, audit and budget preparation, and improve the ability to review financial transactions.
- ✓ Replacing vehicles and equipment nearing the end of their useful life, ready for rotation to back-up duty, or disposal include the Public Works bucket truck (\$154,506), the old rear-end loader garbage truck with a smaller more versatile and fuel efficient mini-garbage truck (\$133,906), several police vehicles, automatic flagging system when crews are working in the streets, town hall roof replacement, HVAC unit replacements, and smaller items are included as well.
- ✓ Staffing Additions. All departments have struggled to keep up with the workload in recent years, the lack of redundancy has created some significant issues, especially during staffing shortages due to vacancies, illness, and vacation, including time to provide necessary training, and dealing with unexpected situations that continually arise. The significant population growth that pushed our small and quiet town of 6,000 to now over 10,000 between census periods, coupled with another 800 units still to be completed in Collins Ridge, the recent annexation of the Moren property that will add an estimated 442 residential units off of Old NC 86 adjacent to Waterstone, and the potential addition of the Capkov project would add 655 units plus commercial development on NC86 and adjacent to UNC Hospital. Plus, there are many other development proposals in the works, including the long-anticipated redevelopment of the Daniel Boone Property. Thus, it's critical that departments not fall further behind in attending to daily services and planning for the future. The following positions are proposed to be added to the General Fund. More details on the justifications for these additions can be found in the document.
 - Public Works Equipment Operator. The department has operated with a maximum of eight employees for over ten years. The Stormwater budget includes an operator for the second year of the financial plan (FY25), to assist public works in being able to perform more proactive maintenance on the town's drainage network. This will allow two full crews to work at times on drainage projects. Budgeted start date is January 1, 2024.
 - Planner II. Position is essential to move the following projects and others forward: Future Land Use Plan and map updates, Unified Development Ordinance re-write, Zoning Map to correspond with the updated future land map and UDO updates, downtown parking study, and master plan the train station site and determine if the project is best suited as public-private development project or a market rate project. Budgeted start date is September 1, 2023.
 - Police Officers – Patrol (2). Continuous absences due to parental leave, illness, training requirements, and vacancies regularly leave patrol rotations understaffed. This has resulted in the lieutenants spending about 60% of their time covering calls and thus not attending to primary duties such as staff development and administrative oversight. Budgeted start date is January 1, 2024.

Water & Sewer Fund: Unique Challenges Contribute to High Water and Sewer Rates

Hillsborough has high rates dating back to the year 2000, when simultaneously, the town started making large debt payments on the reservoir and lost its largest water user (Flynt Fabrics – a textile dyeing facility). Operating the water and sewer system is particularly difficult due to the unique challenges in Hillsborough. As a quick reminder, here are some factors that Hillsborough must deal with and pay for in managing its Water & Sewer Fund that many units do not:

- ✓ Reservoir – few units, especially smaller systems must build reservoirs to meet water demands. Many systems are located close to high volume sources such as rivers, lakes, or aquifers and thus do not need to make proportionally large investments to meet their water demands. Prior to the construction of the West Fork Reservoir, Hillsborough experienced severe droughts and water restrictions.
- ✓ Stringent state mandated rules to protect Falls Lake. Hillsborough is required to treat its wastewater at higher and more expensive standards than most other sewer systems in the United States. The town is located within a watershed that drains into Falls Lake, which is on the EPA's list of impaired waters and has been designated nutrient-sensitive by the N.C. Division of Water Resources. To protect and restore the lake's water quality, the state created the [Falls Lake Rules](#), which

includes stringent rules for the release of treated wastewater. The expensive upgrade to the wastewater treatment plant in 2014 has added an additional \$1.1+ million in annual debt payments that will not be retired until 2034.

- ✓ Large number of sewage pump stations. Hillsborough has far more pump stations per customer than a typical municipality because of its terrain and likely because the infrastructure was preferred decades ago due to its low upfront costs. Pump stations are expensive to operate, require a large amount of staff time, and must be repaired and replaced on regular cycles. Gravity lines require far less cost, time, and maintenance to operate.
- ✓ Small systems lack economies of scale. Larger systems can spread the costs of operations among more customers. This is one reason that many small systems choose to end operations and be served by larger systems if that is an option. Hillsborough did a joint engineering analysis with the City of Durham before the 2014 wastewater plant upgrade to determine if it was cost effective to be absorbed by their water and sewer systems. Due to the distance and other factors, it was still far less expensive for Hillsborough to maintain its own system and not be taken over by the City of Durham. OWASA is in a different drainage basin which is a major permitting hurdle, and the distance between Hillsborough and Chapel Hill-Carrboro also makes getting service from their district not practical.
- ✓ Age of the system. Many parts of the water and sewer system are over 50 years old and overdue for replacement, including water and sewer mains, the larger sewer lift station (River Pump Station). Many of the assets downtown are over 90 years old, such as the Hasell Street water tank along with many of the fire hydrants and valves. These and other aging assets represent significant risks for failure and system outages and environmental damage from sewer leaks, spills, and overflows the longer we wait to replace these lines and stations. While pressure from growth is a major factor on cost, many of these projects must be done relatively soon due to system age, such as the tens of millions of dollars in wastewater collection system needs and replacing miles of the 50-year-old asbestos-concrete water line running along Business Highway 70 that's also our main supply line for emergency water to and from the City of Durham.
- ✓ Growth pressures are overtaxing parts of the water and sewer systems. Proposed developments that are coming in faster and larger than the town has planned for are revealing pinch points in the system that do not allow adequate sewer or water to flow to and from the water and sewer plants to new developments. Many of the choke points are very expensive to address and may require the town to consider ceasing development or temporary moratoriums in certain areas of town. Failure to move forward with some key projects soon will likely result in some sort of development pauses. The town simply cannot afford to address the many needs in all areas of town at once, thus it's going to take time, and require prioritization to make improvements.

One time funding sources being leveraged to pay capital needs in FY24-26

Growth is a double-edged sword – it places additional pressure and costs on the system, but also brings additional revenues in the form of monthly revenues and System Development Fees (SDFs) to assist in paying for their impact on system capacities. The town has elected to use its entire ARPA allocation on water and sewer capital projects since 1) monthly water and sewer bills disproportionately impact lower income households and 2) this benefits all customers by using this source to help pay for much needed capital projects and repairs. The town has also been submitting grant and loan interest applications. In addition, some use of savings is projected to cover projected deficits in coming years. The purpose of highlighting these one-time revenues is to show what is being paid for with non-operating (i.e., not from rates) revenue, and that we must be careful to not get dependent on these sources as they are temporary, not sustainable, often go away quickly, and thus should be limited to funding capital items and not operating expenses! A summary of these revenue sources and potential sources is below:

- ✓ American Rescue Plan Act (ARPA): *\$2.28 million* will be spent from FY23 – FY25.
- ✓ Water – SDF's (collected): *\$845,299* for US-70 water improvement project.
- ✓ Sewer – SDF's (collected): *\$1.03 Million* for collection system rehab.
- ✓ Sewer – Capital Facility Fees: *\$327,386* for the River Pump and Elizabeth Brady Pump Station projects.
- ✓ Water & Sewer – SDFs (projected): The timing of receiving future fees is always difficult as it's dependent on the schedule of developments that often change. Future receipt of these revenues will be used to help pay for major capital projects but are not incorporated into this financial plan. SDFs will be factored into the new Capital Financing Plan that staff will start to work on this summer.
- ✓ Building Resilient Infrastructure and Communities (BRIC) Grant - *\$5.81 million* for the River Pump Station. Covers 70% of the project cost based on current construction estimates.
- ✓ Building Resilient Infrastructure and Communities (BRIC) Grant or STAG Grant - *\$1.01 million* for the OWASA water booster pump station. Covers 70-80% of project cost based on construction estimates.

- ✓ Perpetual Maintenance Fees: \$915,460 to help pay the grant match for the River Pump Station Project.
- ✓ AIA (Grants from the State of N.C.) - \$170,000 for Hasell Street Water Tank and US-70 Waterline Preliminary Technical Memos, Water System Master Planning.
- ✓ Retained earnings (savings). As staff works on the Capital Financing Plan this summer and updates the key financial metrics, such as operating and various debt ratios, depreciation coverage, days of cash on hand, and others, there will be recommendations on how much savings can be used to pay for projects. In the meantime, savings are being used temporarily to cover projected deficits in FY24 and beyond.

Water & Sewer Fund Highlights

- ✓ Financial Overview. Please see page 77 of the budget that shows the breakdown of deficits in more detail, separated by water and sewer operations, as well as the continuation and expansion budgets. The deficits in the Water and Sewer Fund are concerning, especially since rate increases are needed just to fund the continuation budgets due to various increases in operations. You'll notice the deficits are larger on the water operations. This coupled with significant capital needs (about \$25 million over the next three years and more after that) means there will likely be healthy rate increases for several years. These increases even consider the significant use of one-time revenues from grants, system development fees, and other sources. Staff will continue to refine the schedule of capital projects to look for opportunities to defer implementation, where practical and given risk level (e.g., sewage spills, system outages, development moratoriums, and other) to spread costs out to limit the impact on rates. Unfortunately, most of these projects are overdue and need to proceed in the near future. The following are the current total deficit projections:

- ✓ FY24 - \$1,660,259 (11.6% deficit)
- ✓ FY25 - \$1,785,842 (12.6% deficit)
- ✓ FY26 - \$2,317,848 (15.0% deficit)

These deficit amounts need to be addressed to continue maintaining a fiscally strong position as the fund cannot afford to risk having key financial metrics and ratios falling behind industry standards as well as to ensure we meet requirements from the Series 2018 and 2020 Revenue Bonds issued to pay for the revenue expansion. The covenants provide non-negotiable standards for funding levels to provide adequate capacity to make debt payments and remain fiscally sound. If those standards are not met, then the Trustee for the bondholders and/or the Local Government Commission has the right to compel the increasing of our rates to whatever level is needed to meet the various bond coverage ratios. In addition, even getting close to key metrics would have a negative impact on our bond rating and thus make future borrowings more expensive and difficult.

Thus, the next step after budget adoption and coincidentally receipt of the FY22 audit that is likely at the June 12 meeting, is to convene a team of the town's key finance, budget, and utilities staff to further review the budget, three-year plan, and seven-year CIP to work towards developing a Capital Financing Plan. This will develop options and next steps on how best to proceed with funding water and sewer operations, as well as how and when to pay for high priority capital needs (e.g., cash, reserves, system development fees, installment-purchase agreements, revenue bonds, and rate adjustments). This will likely require acquiring the services of firms that specialize in utility system operations, rate setting, debt financing, and more. The town has prior and existing relationships with firms that do this type of analysis. The goal is to have this information to assist with the FY25-27 budget and rate setting process.

- ✓ River Sewer Pump Station Replacement (\$4.74 million). The largest of the two sewer pump stations feeding the wastewater plant is over capacity during times of high flow, is nearly 50 years old, and is in such a state that an entirely new station must be constructed soon. The town received a 70% grant, or \$5.81 million for this project. A major concern is that utilities projects have been coming in much higher, often double engineers' estimates. The total cost of project is estimated at \$8.2 million.
- ✓ OWASA Booster Pump Station for Emergency Water Supply (\$1.58 million). Grants have been received that will cover about \$1 million of the cost. This project is to build a booster pump station to receive water more quickly and in higher volume from OWASA in times of need to provide system redundancy to the entire town. When the town created its south pressure zone, it rendered the existing booster station obsolete as that station was for our central pressure zone.

- ✓ Adron Thompson Facility Repairs and Upgrades (\$3 million). Design has begun and the first debt payment is not anticipated until FY25. This long overdue project addresses serious deficiencies with this facility in terms of safety, lack of restroom facilities, space needs, and more.
- ✓ Exchange Club Sewer Interceptors Design (\$190,000). This line was installed in the early 1970s and recent hydraulic modeling of the collection system revealed a capacity deficiency for existing and proposed growth conditions. There is also some configuration of the mains that may contribute to hydraulic flow restrictions (i.e., there are zig zags that do not provide smooth transitions and allow buildup of corrosive gases). The current brick manholes along this segment are in disrepair. The town has paid to rehabilitate the manholes to keep them from crumbling, leaking, or allowing infiltration. Cost of this project scheduled for FY26 construction is \$1.27 million.
- ✓ Elizabeth Brady Road Pump Station and Force Main Upgrade Design (\$300,000). Construction on this \$4.15 million project is tentatively scheduled for FY25. The station upgrades would enable new development in the Elizabeth Brady basin as well as denser redevelopment of existing sites. The station was rebuilt in 2012 and sized for a quick upgrade of pump capacity which is being implemented now. However, the level of development discharging to this station is much greater than this quick upgrade option which will only hold steady for a few years, if that long. A developer is proposing consolidating two to three existing sanitary sewer pumping stations (Woods Edge Front, Woods Edge Back, and Nazarene) in to a new, larger pumping station. The larger pumping station would be sized for the future buildouts of the basin serving the existing stations to be abandoned as well as the new, proposed development. The developer is working with town staff to provide funding, either with an advance of system development fees or a proffer of future funds, to enable this upgrade to serve the proposed development. The developer would also be required to build the new station and force main, enabling the future abandonment of Wood Edge Front, Woods Edge Back, and Nazarene pumping stations, to town standards with no cost participation by the town. The upgrade to the Elizabeth Brady station will require an upgrade to the existing force main to the wastewater treatment plant to ensure efficient pumping station operations.
- ✓ Eno River Sewer Interceptors. While there are no expenses budgeted for FY24, this project will have a big impact on the three-year financial plan. The \$5 million replacement of this 1970's era sewer main that runs from the River Pump Station to Churton Street is scheduled for FY25. There is \$750,000 for design in FY23 that is currently taking place. In addition to being old, the line is too small, is in poor condition, has never had a significant rehabilitation, the manholes are brick and subject to inflow and infiltration, and the concrete pipes suffer from deterioration due to hydrogen sulfide gas. Sewer currently comes within two feet of the manhole covers during peak flows.
- ✓ Fire Hydrant and Valve Replacement Project (\$200,000 in FY24 as part of \$945,000 project over 4 years). Replace about 150 obsolete fire hydrants dating back to the 1930's and install valves on the hydrant legs where needed in the central pressure zone. Install new valves and piping where redundancy study recommends. Adding valves in locations recommended in a recent system analysis minimizes the number of customers out of water during various line break scenarios.
- ✓ US 70 Business Water Main Improvement and Replacement Project Design (\$275,000). Construction on this \$1.62 million project is scheduled for FY26. Replaces the old asbestos-concrete line that's almost three miles long, prone to breaking due to the material, and serves as the interconnect with Durham for emergency water. There are other key benefits to the project including pressure and redundancy improvements. This is a multi-year, two phase project to 1) replace approximately 4,900 linear feet of 12-inch Asbestos-Cement (AC) water main along Highway 70-A between Highway 86/Elizabeth Brady Road to the Highway 70-A Water Tank with a new 16" ductile iron water main and 2) replace approximately 4,320 linear feet of 12" AC water main along Highway 70-A between Churton Street and Highway 86 with a new 16" ductile iron water main. The cost for phase II, scheduled for FY27, is \$1.35 million.
- ✓ Smaller Maintenance, Repair, Replacement Projects/Equipment, Engineering Reports, and Staffing
 - Sewer hydraulic model scenarios (\$40,000). Updates the collection systems model to accurately identify problems and potential problems related to flow from newly proposed developments.
 - Increased GIS services (\$50,000) to maintain system mapping.
 - Water Plant disinfection process evaluation (\$60,000). Evaluate switching from gaseous to liquid chlorine to improve safety and reduce operational costs.
 - Water & Sewer Air Release Valve Replacements (\$29,074 in FY24, then \$75,000 each of the next two fiscal years). Replace old, obsolete water and sewer air release valves (ARVs). Install new air release valves where needed to enhance system performance. An automatic air release valve provides a critical role in pressurized piping systems such

as our water system and sewer force mains. Air trapped in a pipeline will naturally rise and collect at high points within the system. This trapped air can cause pump failures, faulty instrumentation readings, corrosion, flow issues, and water hammer and surge issues.

- Water main rehabilitation and replacement (\$80,000). Replacing lines as identified in the recent leak detection project in conjunction with analyzing pipe type, average installation date, length of pipe in the system and historical breaks and rates among other attributes, the failure ranking of galvanized and cast-iron pipes are the greatest.
- Wastewater master planning optimization (\$100,000). Provides a roadmap for the future Wastewater Treatment Plant Phase II Upgrade. The master plan will identify alternative treatment technologies and other options to continue compliance with the Falls Lake Rules stringent nitrogen requirements. Compliance with the rules will get increasingly difficult as the town's population grows. The Wastewater Treatment Plant Phase II Upgrade is currently estimated at \$34 million. An in-depth analysis of all options will be critical to ensure that the most cost-effective path to compliance is identified and planned for implementation.
- Utility mechanic (wastewater collections). Needed to keep up with workload, provide relief to current staff who are frequently on-call after hours, attend to significant system maintenance, monitoring, repair, and reporting requirements. It takes new staff, even with prior experience in other locations, significant time to learn the town's systems and be able to respond effectively during emergency situations. Thus, having sufficiently trained staff is essential during times of transition, vacancies, and succession planning.

Stormwater Fund Highlights

- ✓ New equipment. An additional mini-excavator and trailer (\$75,000) allows for two public works crews to perform stormwater/drainage projects simultaneously. This maximizes time efficiency when operating with so few employees.
- ✓ Increased catch basin maintenance (\$25,000). The use of a contractor to clean out the basins annually not only frees staff to work on other projects but delays or negates the need to purchase a very expensive JetVac truck.
- ✓ Stormwater technician. Mid-year addition to keep up with workload, more details are shared in the narrative below.
- ✓ Delay rate increase and fee structure updates one year. This provides further time to analyze revenues, expenses, proposed rate structure changes, and costs associated with pending requirements from the Falls Lake Rules and Upper Neuse River Basin Association, such as complete water quality and watershed improvement projects.

For FY24, the proposed Stormwater Fund budget includes several expansion items, including the mid-year creation of a stormwater technician position, the purchase of a mini excavator and trailer, and recurring contract service funding for catch basin maintenance. In the planning years, there is also a proposed addition of an equipment operator position mid-year in FY25. These proposed additions are the result of system assessments and the creation of an Operations and Maintenance Plan (OMP) intended to keep the town in a proactive position regarding the maintenance of ditches, stormwater control measures, and other parts of the town's stormwater infrastructure. The stormwater technician will assist with inspections, neighborhood evaluations and other tasks as advised by the town's upcoming state stormwater permit audit, and the equipment, contract services and future staff expansion will provide the resources to address issues identified by the inspections, evaluations, and audit. These additional staff positions will also help maintain the existing staff capacity for serving in technical advisory roles on regional partnerships and as an educational and outreach resource for town residents.

These expansions will put the Stormwater Fund in a deficit position of approximately \$300,000 per year, which can be absorbed in FY24 due to accumulated fund balance but will necessitate future rate increases. At the January budget retreat, staff indicated a rate increase and adjustments to the current tier system for FY24 was likely, but due to other proposed revenue changes and the accumulated fund balance, the recommendation is to defer the rate increase to next year.

Along with a likely rate increase in FY25, between this budget and next year's proposal staff will further model a plan for smaller ongoing rate increases to avoid large rate adjustments in the future. In addition to the ongoing deficit, the need for ongoing rate increases will be driven by the readoption of the Falls Lake Rules. The readoption of these rules is anticipated to include an expanded version of the current Upper Neuse Basin Associations (UNRBA) Interim Alternative Implementation Approach (IAIA) joint compliance program. This program is an investment-based approach that currently requires the town to complete water quality and watershed improvement projects. The expanded joint compliance program under the future re-adopted Falls Lake Rules is expected to require increased investment in water quality and watershed improvement capital projects which are not currently funded in the proposed budget.

Employees

- ✓ Merit Pay and Cost of Living Adjustment (COLA). Compensation and staying competitive with the market continue to be a major challenge for all employers, regardless of sector in the economy. Staff continue to monitor what other local governments in our market plan to do for employees in terms of merit and COLA and will bring back a final recommendation for the June 12 meeting. This will provide enough time to get an accurate survey of what others in the market are doing to help determine what compensation adjustments should be made for FY24. As placeholder figures the draft budget includes the same average raise and COLA amounts used for this fiscal year, FY23 (e.g., 3.25% average merit increase for employees with a range of 2.25% to 4.5%, and a flat \$1,000 per employee COLA). These placeholder figures may be sufficient, but we need to be prepared to increase one or both areas depending on the market survey results.
- ✓ Health insurance. There will no increase to the town's health insurance coverage this year.

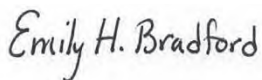
Moving Forward

For the reasons covered in this message changes to this proposed budget are expected during the review process, as well as during FY25 as new information becomes available and conditions change. Therefore, please do not hesitate to contact me, Budget Director Emily Bradford (Emily.bradford@hillsboroughnc.gov or 919-296-9427), Budget & Management Analyst Josh Fernandez (josh.fernandez@hillsboroughnc.gov or 919-296-9428), or Administrative Services Director Jen Della Valle (jen.dellavalle@hillsboroughnc.gov or 919-296-9424) if you need additional information, have suggestions, concerns, or would like to propose alternatives, Town staff will make every effort to respond quickly and objectively to help you develop a budget that you feel best addresses the needs of the community! Finally, a big "thank you" goes to all town employees, department and division heads, and the budget team for their work in preparing this year's document!

Sincerely,



Eric J. Peterson
Town Manager



Emily H. Bradford
Budget Director



Jen Della Valle
Administrative Services Director